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Past Performance and Earnings Management: The Effect of Free Cash Flow

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Abstract

The main objective of this study is to discuss the effect of free cash flow as a moderating variable on managers' decisions as regard earnings management. Companies with free cash flow are expected to refrain from taking opportunistic actions such as earnings management. The research used quantitative methods with sub-group moderating analysis. It is found that there is a significant relationship between past performance and earnings management, where the free cash flow is the moderating variable. The effect of past performance on earnings management is shown to slightly increase as free cash flow is considered. The findings of this study prove that earnings management is a practice that is often done by utilizing the flexibility of accounting recording and recognition mechanisms. Past performance becomes the main variable in encouraging managers to manage earnings by reducing revenue in the current period. This research can also be a reference in explaining managerial behavior and can be a reference to improving ethical human resource capabilities. This research focuses on companies in Indonesia that conduct earnings management by lowering profits as a result of declining past performance and examines aspects of free cash flow that reinforces the conduct of earnings management.

Keywords: Earning Management, Past Performance, Free Cash Flow

JEL Classification Code: G3, G4, M40, M42

1. Introduction

The manager's flexibility in regulating, changing, or changing a particular accounting method shows that everything that is measured in the financial statements can be managed strictly. Increasingly, high market uncertainty, differences in interests, and diversity of stakeholders make the concept of earnings management more important for company managers. In achieving the best compromise between shareholders and stakeholders, company management sets several managerial policies, namely, by making intentional or unintentional interventions in the process of presenting financial information for certain income levels (Tang et al., 2015). Earnings management methods commonly used by managers are to use and manipulate corporate financial data that apply accrual data (Bartov, Givoly, & Hayn, 2002; Healy & Wahlem, 1999; De Jong, Mertens, van der Poel, & van Dijk, 2014; Francis, Hasan, & Li, 2016; Kothari, Mizik, & Roychowdhury, 2015; Zang, 2012). Research by Gunny (2010), Healy and Wahlen (1999), and Tang et al. (2015) prove that earnings management is able to improve positive company performance, but not a few other studies also prove that earnings management supports company performance (Cohen & Zarowin, 2010; Kothari et al., 2015; Tang & Chang, 2015). Earnings management must be done in the long run and profit will be decreased (Dichev, Graham, Campbell, & Rajgopal, 2013).

There are various motivations of managers in managing earnings, namely, the existence of capital market pressures such as an increase in stock prices (Teoch, Welch, & Rao, 1998), reduction or decrease in the probability of debt failure (Dechow & Skinner, 2000), as well as an increase in earnings and bonus managers (Holthausen, Laker, &

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Sloan, 1995). This is in line with the concept of agency theory, which explains that the motives of management to manage earnings depend on the manager's own interests and have a direct impact on the managerial performance appraisal of shareholders (DeFond & Park, 1997; Kontesa, Brahman, & Tong, 2020; Subramanyam, 1996; Kumari & Pattanayak, 2017; Zhang, Uchida, & Bu, 2013). Therefore, the company's current income is strongly influenced by earnings management practices by managers (Bautista et al., 2005), which raises big questions regarding the quality, significance, and reliability of financial information due to irregularities in financial and accounting data presented by the company (Tang et al., 2015).

Earnings management has brought many large companies in Indonesia into legal trouble. The largest airline company Garuda Indonesia carries out earnings management by making revenue recognition prematurely and Indonesia's largest insurance company Jiwasraya failed to invest a number of company funds, which resulted in the company failing to pay a number of customer insurance claims. This research is important because there are still many studies that have not been able to prove that managerial earnings management is caused by a number of pressures received by managerial, which pressure is represented by the value of the previous year's low-income achievement. And this study also wants to prove that the free cash flow available is a financial variable that strengthens managerial earnings management when income attainment tends to below. The results of this study are expected to have implications in business management practices, namely, investors are expected to be more careful in considering their investments when company performance tends to decline and investors can also be more critical in the opportunity manager in utilizing the company's excess cash so that short-term investments do not harm investors and companies.

This research contributes to the development of agency theory and free cash flow theory, the results of our study indicate that with managers highly dependent on the achievement of their performance which is evaluated through the achievement of income, when the income achieved tends to be low managers will behave opportunistically by making earnings management so that short-term performance can be reached. Our results also contribute to explaining the free cash flow theory, which shows that when companies have low free cash flow the stronger the manager's tendency to do earnings management because managers are required to be able to invest a number of funds that can provide long-term benefits. Our study also succeeded in providing other findings, namely related to managerial tendencies in earnings management, most studies found that managerial tends to increase profits, but in our study managed to prove that when the performance of the previous year tends to fall, management carried out by managerial is to reduce the value of earnings current year or tends to be the same as the achievement of the previous year, which is indicated through negative earnings management values.

2. Literature Review

2.1. Earning Management and Past Performance

The earnings management action has triggered big companies into the case of widespread accounting reporting scandals such as Worldcom, Enron, Kimia Farma, and more recently Garuda Indonesia. Companies with accounting scandals solely carry out earnings management to cover up poor company performance by increasing revenue and profits (Habib, Uddin Bhuiyan, & Islam, 2013). This was done in order to meet the public's expectations of the company's sustainability, so that company executives made adjustments to the financial statements to achieve the target (Bartov, Givoly, & Hayn, 2002; Healy & Wahlem, 1999). Research by Gang, Zezhong, Travlos, and Hong (2007) also proved that earnings management is done so that losses in financial statements can be avoided. Dang et al. (2020), the practice of earnings management also shows that accounting numbers are very important so that many management companies try to present the best revenue, because of the quality of earnings very positively related to the company's book value, and this refers to the relevance of disclosure of information, which improves earnings quality, as well as credibility of the reported book value. In applying earnings management practices, managers need to use judgment and some accounting policies.

Income is very vulnerable to being used in earnings management practices, companies can postpone restructuring expenses associated with acquisitions, carry out large-scale write-offs that can be used to boost company revenue. Managers can also accelerate the recognition of earnings before the end of the period, where sales transactions are usually carried out during the closing periods of the book so that the company's revenue increases significantly at the end of the period.

H1. *There is a significant relationship between past performance and free cash flow.*

2.2. Earning Management and Free Cash Flow

Slack resources theory explains that cash is a high discretionary dimension of financial resources (George, 2005), as long as managerial has the flexibility of implementing policies (Sharfman et al., 1988). Huynh (2020) and Huynh and Nguyen (2019) also explains that good earnings quality can reduce market risk and will improve company performance, this is a managerial driving force for flexibility in accounting principles, and in other words flexibility in applying accounting principles can create unethical behavior such as earnings management. Therefore, in an environment where there is no effective monitoring of disciplinary action by regulators, stakeholders or outside agents, some company managers will pursue their personal benefits by optimizing free cash flow (Jensen, 1986; Gul & Tsui, 1998; Armstrong et al., 2015). Richardson Research, 2006); Wei and Zhang, 2008 prove that free cash flow causes excessive investments made by managers. Management continues to invest free cash flow to maximize their own compensation, which optimizes free cash flow results in low growth opportunities and produces investments that are not of high value (Jensen, 1986; Gul & Tsui, 1998; Armstrong et al., 2015). In line with agency theory, it is explained that companies with low growth opportunities tend to invest free cash flow in projects that are less or unprofitable, which in turn will reduce revenue and will result in low stock values (Habib, 2011). Chalak et al. (2012) suggested that there is a direct relationship between earnings management and free cash flow. However, the results of Ross et al. (2000) revealed a different thing that companies that have high free cash flow values tend not to do earnings management because some corporate investors are owners while companies are more concerned with the amount of free cash flow used to distribute dividends.

H2. *Free cash flow moderates the relationship between past performance and earnings management.*

Several previous studies have been conducted related to the direct relationship between earnings management and company performance. Al-Absy et al. (2020) state that a high level of control over managers will affect the behavior and performance of the manager so that it can increase company performance and reduce the level of company performance. However, as previously explained, not much research has been done regarding free cash flow as a moderating variable between the relationship of past performance with earnings management. Free cash flow is usually optimized by companies to make investments, but investments tend to be less profitable investments, which ultimately reduce income, and on the other hand companies with high free cash flow tend to focus on dividend distribution. This shows that free cash flow can affect the relationship between past performance and earnings management. The free cash flow becomes the moderating variable between past performance and earning management.

3. Research Methods and Materials

3.1. Population and Sample

The participants of this study are companies listed on the Indonesian stock exchange in the year 2020. In selecting the participants, the stratified random sampling technique was used. Companies were divided into three groups of industry, namely, manufacturing, service, and trading industries. From each group of industries, 50 companies were randomly selected that made up 135 companies participated in this study. However, due to missing data and some were found to be the outlier, only 135 companies were illegible to be analyzed as the participants of this study. This study is a cross-sectional where data was taken from each participant's financial statements in one particular period of time that is in the year 2017 for past performance and 2018 for free cash flow and earning management.

3.2. Data Analysis Method

The data is analyzed using moderated regression analysis where earning management is the dependent variable, past performance is the independent variable, and free cash flow is the moderating variable. The data is analyzed using sub-group moderating analysis, followed by the Chow F test and the linear regression analysis.

Empirical model equation

An ordinary least squares multiple regression is applied to test the hypotheses. The main regression model is defined in the following equation:

$$EM = \alpha + \beta 1 P.Form + \varepsilon$$
$$EM = \alpha + \beta 1 P.Form + \beta 2 FCF + \varepsilon$$
$$EM = \alpha\ \beta 1 P.Form + \beta 2 FCF + \beta 3 P.Form{*}FCF + \varepsilon$$

Where:

EM = Earning Management
P.Form = Past Performance
FCF = Free Cash Flow

3.3. Research Variables and Variables Measurements

3.3.1. Proxy for Earnings Management and Past performance

Earnings management is the dependent variable of this study. Since there are several kinds of earnings management, accrual-based earnings management is used in this study. From the literature, it is found that most of the earnings management practices are the accrual earnings management (Healy & Wahlen, 1999; Fields, Lys, & Vincent, 2001; Schipper, 1989).

Earnings management is proxy by unexpected or DACs. Prior to estimating DACs, total accruals (TAC) are calculated as:

$$TACCjt = NIBEjt - CFOjt$$

$$TACCjt/TAjt - 1 = \beta 1(1/TAjt - 1) + \beta 2(\Delta REVjt/TAjt - 1) + \beta 3(PPEjt/TAjt - 1) + \beta 4(ROAjt/TAjt - 1) + \varepsilon jt$$

Non-discretionary accruals

$$DACCjt = \beta 1(1/TAjt - 1) + \beta 2(\Delta RE5Vjt - \Delta RECjt)/TAjt - 1) + \beta 3(PPEjt/TAjt - 1 + \beta 4(ROAjt/TAjt1)$$

$$DACCjt = (TACCjt/TAjt - 1) - NDACCjt$$

Where:

TACCjt: total accruals for firm j in year t
NIBEjt: Net income before extraordinary item for firm j in year t
CFOjt: Operating cash flow for firm j in year t
TAjt−1: total asset for firm j in year t−1
ΔREVjt: change in sales for firm j in year t
PPEjt: gross property, plant, and equipment for firm j in the year t
ROAjt: Return on assets for firm j in the year t
NDACCjt: Non discretionary accruals for firm j in the year t
ΔRECjt: Change accounts receivable for firm j in the year t
DACCjt: Discretionary accruals for firm j in the year t

Past performance is the independent variable of this study. Past performance is measured by the revenue (REV) of the past year. It is the average revenue received in the year of 2017. It is computed as:

$$(REV_{t-1} - REV_{t-2})/REV_{t-2}.$$

Where:
REV_{t-1} = revenue at time t-1;
REV_{t-2} = revenue at time t-2.

3.3.2. Moderating Variable Proxies

The moderating variable of this study is free cash flow. Free cash flow is an excess that is needed to fund all projects that have a positive net present value. Free cash flow is calculated using the formula Ross et al. (2000), the following:

$$FCFit = OCFit - CEit - NWCit$$

Where:
FCFit: Free cash flow for firm j in the year t
OCFit: Operating cash flow for firm j in the year t
CEit: Capital expenditure for firm j in the year t
NWCit: Net working capital for firm j in the year t

4. Research Results

4.1. Statistical Descriptive and Hypothesis Results

Table 1 shows the results of descriptive statistical testing of the variables used in this study. The descriptive statistical analysis includes the values of min, max, mean and standard deviation. Table 1 shows that earnings management is carried out by all companies either by lowering the achievement of profits or increasing the achievement of profits than actually indicated by the min and max values obtained. Whereas for free cash flow owned by companies, 36% of companies have negative FCF and around 64% have positive FCF, which shows that most companies are able to support the company's operations.

4.2. The Result of Hypothesis 1–Earnings Management and Past Performance

We were testing the null hypothesis that past performance has no relationship with the practice of earnings management with the use of ordinary linear regression analysis. The result indicated that past performance explains 9.2% of the variance (R^2 = 0.0918). With the use of ordinary linear regression analysis, it was found that past performance significantly related to the earnings management ($F(1,133) = 13.46$, $p < 0.01$). The null hypothesis is rejected. This finding indicated that as past performance that was represented by the last year's growth of revenue getting smaller Table 2. (β = -0.07), then the practices of earnings management tend to increase.

4.3. The Result of Hypothesis 2–Earnings Management and Free Cash Flow

The null hypothesis that free cash flow cannot be used as the moderating variable in the relationship between past performance and earnings management was tested. As in the sub-group moderating analysis, the data were grouped into two groups based on the value of free cash flow. The first group was the past performance and the earnings management that had free cash flow below average, while the second group was the past performance and the earnings management that had free cash flow above average. The R^2 of the first group (0.095) was higher than the R^2 of the second group (0.082). This indicated the existence of moderating effect. However, this method received some critiques therefore further analysis with the Chow test was needed.

Table 1: Statistic Descriptive

Variable	Min	Max	Mean	SD
Earning Management	-0,58	0,24	-0,0543	0,1196
Free Cash Flow	-4,534	19,208	1,071	1,678
Past Performance	-0,91	2.15	0,1202	0,3651

Table 2: Statistics The Sub Group Moderating

	Group 1	Group 2	Group Total
R Square	0,09495	0,08188	0,09188
F Value	11,01638	2,31885	13,45726
F-Sig.	0,00124	0,13988	0,0003
SS Residual	1,34703	0,341136	1,74152
P-Value of Past Performance	0,00124	0,13985	0,00035
Coefficients	-0,06597	-0,11779	-0,07119

Table 3: F-Chow Test

	Past Performance as Predictor	Past Performance and Free Cash Flow
R Square	0,09188	0,11171
F Value	13,45727	8,30061
F-Sig.	0,00035	0,00040
P-Value	0,00035	0,08838
F-Chow Test	4,139	
F-table	3,968	

The Chow test then was done to test if the free cash flow can be the moderating variable in the relationship between past performance and earnings management practices. It was found that the computed F-Chow (F(4,131) = 4.14) is higher than the table F (F(4,131) = 2.44). Therefore, the null hypothesis is rejected. Free cash flow had a moderating effect on the relationship between past performance and the earnings management practices. As the free cash flow decrease (β = -0,071) the effect of past performance on earnings management practices is getting stronger.

Comparing the result of a linear regression analysis between past performance and earnings management without and with free cash flow, resulted in different R^2. The R^2 with free cash flow ($R^2 = 0.098$) is higher than the R^2 without free cash flow (0,092). This result indicates that as managers consider the free cash flow, the effect of past performance to the practice on earnings management getting slightly stronger.

5. Discussion

Accounting standards provide a mechanism for managers to make various adjustments in accounting records and recognition. The flexibility of this mechanism encourages managers to adjust income and profits to a more stable level and is considered safe for all stakeholders. This study seeks to explain related to previous financial performance issues that encourage managers to choose opportunistic accounting records. And this study also seeks to explain the effects of interactions between previous financial performance and the free cash flow available to conduct earnings management.

The results of the analysis of earnings management in this study provide evidence that in utilizing the flexibility of recording and recognition of transactions, companies conduct earnings management with income decreasing/income minimization methods seen from the average value of earnings management of -0,053. The results of testing between previous financial performance and earnings management in this study indicate that previous financial performance has a negative effect on earnings management. This shows that, when the previous financial performance decreases, there will be an increase in earnings management. This is in line with the research of Chung et al. (2005), which explains that when the income of the previous year tends to decrease, then managers will behave opportunistically by reducing the level of income and profits in the current year so that the company's performance does not appear to fluctuate (Roychowdhury, 2006; Zang, 2012).

Another contribution of this research is related to how the company's free cash flow strengthens the negative influence of previous financial performance on earnings management. The low level of free cash flow in a company increases the likelihood of earnings management practices. This is because free cash flow is an important determinant in determining company value. Jensen (1986) argues that companies with low free cash flow will have greater opportunities in managing earnings because the company has agency problems. Consistent with the concept and research Chung et al. (2005), our study also proved that when a company has low free cash flow due to low earnings performance, the company will tend to report lower profits, which influence the past performance on earnings management practices becomes stronger.

6. Conclusions

Managers of companies with excessive free cash flow will make investment decisions that are not always in the best interest of the shareholders and use accounting discretion to increase reported earnings. It is important for those who are interested in the financial performances of a firm such as investors or analysts to look at the past performance of the firm since it determines the current and future quality of its financial reports. Since free cash flow strengthens the effect of a firm's past performance on the quality of its income reporting as indicated by the earning management, then it needs to be considered too.

It is in the agency cost perspective that companies with low growth opportunities tend to invest with free cash flow in some unprofitable projects, which represents a high discretionary dimension of financial resources. And, in an environment where there is no control, disciplinary action such as earnings management will be taken by managers in pursuit of their personal gain. The results of this study also show that managers do not have the obligation to disclose to investors the managerial reasons for investment decisions, thereby increasing the opportunities for managers to transfer company resources.

This study has some limitations. We are focusing on the growth of the revenue in measuring past performance, however there might be some other measurement of past performance that could give a better result such as income or the combination of income and revenue. Also, the R^2 of this study is quite low – 9.19 percent. And the difference of R^2 with or without the moderating variable is only 0.6 percent. For future studies, it is recommended to seek at the time lag from past performance to the current earning management period and to use other measures of past performance in determining the practices of earning management of a firm.

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